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No. 71-1194

In the Supreme Court of the United States

OCTOBER TERM, 1971

QUINN AND COMPANY, INC., and JOHN DORNACKER, PETITIONERS

v.

SECURITIES AND EXCHANGE COMMISSION

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE TENTH CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION IN OPPOSITION

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. A) is reported at 452 F.2d 943. The findings and opinion of the Securities and Exchange Commission (Pet. App. B) are not yet reported.

JURISDICTION

The judgment of the court of appeals was entered on December 17, 1971. The petition for a writ of certiorari was filed on March 15, 1972. The juris-

diction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Whether the Commission and the court of appeals properly determined that a person who acquired securities directly from the issuer in payment for properties which he transferred to the issuer with the intention of immediately selling the securities to the public to obtain cash for the transferred properties, and who then sold the securities to the public through a broker-dealer using the facilities of a stock exchange to effect most of the sales, was an "underwriter" within Section 2(11) of the Securities Act of 1933.

2. Whether the exemptions under Section 4(3) (dealer transactions) or Section 4(4) (broker transactions) of the Securities Act of 1933 apply where a statutory underwriter is a party to the transactions in question.

STATUTES INVOLVED

The pertinent provisions of Sections 2(11) and (12) and Sections 4 and 5 of the Securities Act of 1933, as amended, 15 U.S.C. 77b(11), 77b(12), 77d, and 77e, are set forth at Pet. App. C, pp. 24a-27a.

STATEMENT

The Commission suspended petitioner Quinn and Company, Inc. ("Quinn Inc.") from membership in the National Association of Securities Dealers, Inc.

for 15 days and petitioner John Dornacker from association with any broker or dealer for a 20-day period to begin with Quinn Inc.'s suspension, for willful violations of the registration provisions of the Securities Act of 1933 (the Act). The violations involved the offer and sale of 25,000 shares of the common stock of Mountain States Development Company ("Mountain") by Quinn and Company ("Quinn Co."), a partnership predecessor of Quinn Inc.,[1] for the account of Ted M. White, for which no registration statement had been filed or was in effect. The court of appeals affirmed.

The record before the Commission, to which the parties stipulated, established the following facts: White acquired 37,000 shares of Mountain stock directly from Mountain in exchange for certain property interests which he owned. He accepted Mountain stock, intending to resell it as soon as possible in order to obtain cash representing the sale price of the properties. Shortly after the issuance of the stock to White, he delivered it to Quinn Co. to sell for him. Quinn Co., through Dornacker, sold 25,000 shares of the stock to the public, most of which were sold on the Salt Lake Stock Exchange and the balance in the over-the-counter market and to a retail customer of Quinn Co. (Pet. App. B, pp. 8a-9a, 11a, 12a n.10.)

On these facts, the Commission found that White acquired his Mountain shares directly from the issuer

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[1] Petitioner Dornacker was a general partner of Quinn Co., and is a vice president and stockholder of Quinn Inc.

(Mountain) with the intention, which he carried out, to begin immediately to resell them to the public. It concluded that White therefore was an "underwriter" within the language of Section 2(11) of the Act—"any person who has purchased from an issuer with a view to * * * the distribution of any security"—and hence that his sales were not covered by the statutory exemption from registration under Section 4(1) for "transactions by any person other than an issuer, underwriter, or dealer" (Pet. App. B, pp. 10a-14a).

The Commission rejected the contention that White was not an underwriter because he was an investor who had been fraudulently induced by Mountain to purchase the stock (*id.* at pp. 12a-13a). It also held that the sales of White's stock by Quinn Co. and Dornacker were not exempt from registration under Section 4(3) or Section 4(4) of the Act. Those sections were intended to facilitate trading in securities already in the hands of the public and do not, the Commission held, exempt transactions by a broker selling unregistered stock for an underwriter since in that circumstance the broker would be participating in a distribution in violation of the registration provisions (*id.* at pp. 14a-17a).

The court of appeals sustained the Commission's order. It agreed that White was an underwriter and that no exemption from registration was available for the sales of White's stock (Pet. App. A, pp. 3a-4a). It rejected the argument that the number of shares involved was insufficient to constitute a public

distribution covered by the registration provisions of the Act (*id.* at p. 4a).

ARGUMENT

This case involves only the application of established principles to the particular facts. The decision below is correct, and there is no conflict or other reason warranting further review.

1. The Commission correctly held that White was an "underwriter" and that therefore the transactions were not "by [a] person other than an * * * underwriter" and exempt from registration under Section 4(1).[2] Section 2(11) defines "underwriter" as "any person who has purchased from an issuer with a view to * * * distribution * * *." Petitioners argue that the sale of a small amount of securities, such as was involved here, is not a "distribution" within Section 2(11).

In the Act, Congress sought to "provide full and fair disclosure of the character of securities sold * * *"[3] by requiring registration of securities and delivery of a statutory prospectus to prospective pur-

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[2] The person claiming an exemption from registration must prove that the exemption applies, and thus petitioners had the burden of establishing that White was not an underwriter. See *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119, 126. Furthermore, the terms of an exemption are strictly construed against one claiming it. See *United States* v. *Custer Channel-Wing Corp.*, 376 F. 2d 675, 678 (C.A. 4), certiorari denied, 389 U.S. 850; *Securities and Exchange Commission* v. *Sunbeam Gold Mines Co.*, 95 F. 2d 699, 701 (C.A. 9).

[3] Preamble to the Securities Act, 48 Stat. 74.

chasers. See H. Rep. No. 85, 73d Cong., 1st Sess., pp. 3-8 (1933). It determined, however, that although the protections afforded by registration were needed for transactions occurring during the distribution of securities to the public in an offering emanating from the issuer of the securities, registration is not necessary for an investor's trading transactions after the issuer's distribution to the public. See *id.* at pp. 5, 15. Accordingly, the Act distinguishes public distribution from subsequent trading; while transactions in unregistered securities are prohibited (Section 5 of the Act, 15 U.S.C. 77e), transactions by persons not involved in the distribution process are exempted (*e.g.*, Section 4(1) and Section 4(2) of the Act). And in order to prevent an issuer from indirectly effecting an unregistered public distribution by using an intermediary, the broad definition of "underwriter" in Section 2(11) includes intermediaries, thereby requiring registration for their transactions. See *Securities and Exchange Commission* v. *Chinese Consolidated Benevolent Ass'n, Inc.*, 120 F. 2d 738, 741 (C.A. 2), certiorari denied, 314 U.S. 618.

In view of the statutory design that requires registration when the issuer uses an intermediary, it is clear that the term "distribution" in Section 2(11), with respect to a person who, like White, acquires shares from the issuer with a view to immediate resale to the public, means the same as the term "public offering" in Section 4(2) for transactions by the issuer itself.[28] See, *e.g.*, *Gilligan, Will & Co.* v. *Securi-*

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[28] Section 4(2) exempts from registration "transactions by an issuer not involving any public offering."

ties and Exchange Commission, 267 F. 2d 461, 466 (C.A. 2), certiorari denied, 361 U.S. 896; *Securities and Exchange Commission* v. *Computronics Industries Corp.*, 294 F. Supp. 1136, 1139 (N.D. Tex.); *Oklahoma—Texas Trust*, 2 S.E.C. 764, 769, affirmed *sub nom. Oklahoma—Texas Trust* v. *Securities and Exchange Commission*, 100 F. 2d 888 (C.A. 10). As to issuer transactions, it is settled that the number of shares involved does not determine whether the Section 4(2) exemption is available (see *Securities and Exchange Commission* v. *Ralston Purina Co.*, 346 U.S. 119), and that the offer or sale to the public of even an insubstantial amount of securities constitutes a "public offering." White's sales were therefore a "distribution" for purposes of Section 2(11); the fact that the sales were made principally on a stock exchange, and thus involved thousands of unidentified potential purchasers, establishes that this was a "public offering" and hence a "distribution".[6]

Petitioners' other arguments that White is not an "underwriter" are no more pursuasive. The state-

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[6] Petitioners' reliance (Pet. 12) upon a statement in the House Committee Report (H. Rep. No. 85, 73d Cong., 1st Sess., pp. 13-14 (1933)) indicating that registration is required when an offering reaches "significant proportions" is misplaced. The Committee's statement concerned certain secondary distributions (where controlling persons of the issuer who are not themselves statutory underwriters redistribute securities). White, on the other hand, purchased the shares in question here from the issuer with a view to immediate resale, and thus he was an intermediary in a public distribution emanating from the issuer itself. Similarly, Rule 154 under the Securities Act (17 C.F.R. 230.154), to which petitioners also refer (Pet. 17-18), deals with secondary distributions and hence has no relevance here.

ment in the introductory clause in Section 2 of the Act, on which petitioners rely (Pet. 11), that the definitions set forth in that section are to control "unless the context otherwise requires" has no application here. Classifying White as an "underwriter" effectuates the Act's purpose of assuring that an issuer cannot circumvent the registration requirements by publicly distributing its stock through an intermediary.

Nor is it significant that White was not in control of Mountain and could not compel it to file a registration statement (Pet. 10-11, 12, 14). Although control is a factor where a secondary offering is involved (see, *e.g.*, *Pennaluna & Co., Inc.* v. *Securities and Exchange Commission*, 410 F. 2d 861, 865 (C.A. 9), certiorari denied, 396 U.S. 1007; *Securities and Exchange Commission* v. *Culpepper*, 270 F. 2d 241, 245-246 (C.A. 2)), White's transactions were part of a primary distribution emanating from the issuer itself, not a secondary offering.

Petitioners claim (Pet. 16) that White should not be deemed an underwriter since, as an unsophisticated individual lacking "knowledge and information material to his purchase of Mountain's stock," he is unlike "a securities professional, equipped by experience and knowledge to bargain for registration * * *." The term "underwriter" in the Act, however, "is defined not with reference to the particular person's general business but on the basis of his relationship to the particular offering. No distinction is made between professional investment bankers and rank ama-

teurs. Any person who performs one of the specified functions in relation to the offering is a statutory underwriter * * *." I Loss, *Securities Regulation* 547 (2d ed. 1961). See also *Securities and Exchange Commission* v. *Chinese Consolidated Benevolent Ass'n, Inc., supra,* 120 F. 2d at 741.

Moreover, White was hardly an "ordinary investor," as petitioners suggest. He acquired the stock in exchange for properties pursuant to direct negotiations with the issuer. His only objective was to obtain the sale price of the properties on resale of the stock, and Mountain assured him that he could do so. Unlike an ordirary investor, White had no interest in any of the investment aspects of the Mountain stock. In these circumstances, the issuer (Mountain) was using White as an intermediary to raise cash from the public in order to buy his properties. As the Commission pointed out (Pet. App. 11a-12a):

> [White's] acceptance of the Mountain stock and immediate resale for cash did not differ in essence from an arrangement whereby the issuer sold the stock to the public for cash and used the cash so raised to buy White's properties, an arrangement which clearly would have required registration for the securities so sold to the public. If the view that the same securities could flow from the issuer to the public without registration merely because of the interposition of the seller of property to the issuer under these circumstances were upheld, public distributions of securities could be readily effected without com-

pliance with the registration, prospectus and other protective provisions of the Securities Act, contrary to the basic policy of that Act.

The decision below that White was an underwriter is not, as petitioners contend (Pet. 8-11), inconsistent with *Securities and Exchange Commission* v. *Ralston Purina Co.*, *supra*. This Court there held that Ralston's offer of its securities to employees was a public offering for which registration was required under the Act. Unlike Ralston's employees, White was an intermediary in distributing to the public the stock which he received from Mountain, and was used by Mountain to obtain from the public the cash to buy his property. Moreover, even though he was an underwriter with respect to the distribution, he is not precluded thereby from recovering damages from Mountain based on its alleged violations of the Act.[5]

2. Contrary to petitioners' contention (Pet. 18-24), the sales of White's Mountain stock by Quinn Co. were not exempt from registration under Sections 4(3) and 4(4) of the Act. The exemptions under

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[5] See, *e.g.*, *Katz* v. *Amos Treat & Co.*, 411 F. 2d 1046, 1054 (C.A. 2) (suit permitted under civil liabilities provisions of Section 12 of the Act, 15 U.S.C. 77*l*, for violation of the registration and antifraud provisions, even though plaintiff-purchaser may be an underwriter); *John R. Lewis Inc.* v. *Newman*, 446 F. 2d 800, 806 (C.A. 5) (recovery affirmed in private action under antifraud provisions of the federal securities laws over contention that the plaintiffs were dealers and underwriters, on the ground that the plaintiffs were nonetheless members of the class entitled to the protection of the antifraud provisions); VI Loss, *Securities Regulation* 3829 (Supp., 1969).

these sections, like the exemption in Section 4(1), distinguish distributions emanating from an issuer from subsequent trading transactions by investors, and exempt only the latter.

Section 4(1) exempts from registration transactions by persons other than those involved in the distribution process—in the words of the statute, "transactions by any person other than an issuer, underwriter, or dealer." "Dealer" is defined in Section 2 (12) as including brokers like petitioners, who trade as an agent for their customers rather than as a principal. Issuers' and underwriters' transactions with the public are always part of the distribution process; dealers' transactions, on the other hand, may not be, since a dealer "is often concerned not only with the distribution of securities but also with trading in securities * * *." H. Rep. No. 85, 73d Cong., 1st Sess., p. 16 (1933).

The exemption in Section 4(3) was provided to differentiate between these two dealer activities. Thus, while Section 4(3) exempts generally "transactions by a dealer," there are several exceptions. Clause (C) excepts "transactions as to securities constituting the whole or a part of an unsold allotment to or subscription by such dealer as a participant in the distribution of such securities by the issuer or by or through an underwriter"—that is, those transactions which are part of the actual process by which securities are distributed from the issuer to the public. In addition, since "the dealer might easily evade the [registration] provisions of the act by a claim that

the securities he was offering for sale were not acquired by him in the process of distribution but were acquired after such process had ended * * *" (H. Rep. No. 85, 73d Cong., 1st Sess., p. 16 (1933)), clauses (A) and (B) except all dealer transactions during a specified period immediately following the commencement of the distribution. During that period there must be compliance with the registration provisions even though the dealer is engaging in ordinary trading transactions (*ibid.*). With respect to the transactions in this case, White was an underwriter and thus by definition a participant in a distribution, and accordingly petitioners' activities were part of the distribution process itself and not within the Section 4(3) exemption.

By reason of the time period exception in clauses A and B of Section 4(3), an ordinary investor would be precluded from selling his securities through a dealer during the specified period unless the registration provisions are satisfied. Section 4(4) was intended to meet the problems which this might entail for investors. It exempts from the registration requirements unsolicited brokerage transactions, which are transactions executed by a dealer acting as a broker for his customer without soliciting the buyer. This exemption was not intended, as petitioners argue (Pet. 22), to exempt transactions in which the seller is an underwriter, but instead was aimed only at assuring that ordinary investors could resell through brokers at any time without concern for the registration provisions. The House Committee Report

explained (H. Rep. No. 85, 73d Cong., 1st Sess., p. 16 (1933)):

> Individuals may thus dispose of their securities [under this exemption] according to the method which is now customary without any restrictions imposed either upon the individual or the broker. This exemption also assures an open market for securities at all times, even though a stop order against further distribution of such securities may have been entered. Purchasers, provided they are not dealers, may thus in the event that a stop order has been entered, cut their losses immediately, if there are losses, by disposing of the securities. On the other hand, the entry of a stop order prevents any further distribution of the security.

As this makes clear, Section 4(4) is not applicable when the selling customer is a dealer. "*A fortiori* it cannot be available when the seller is an underwriter [such as White] or issuer," since public transactions involving underwriters and issuers are always part of the distribution and hence subject to registration. I Loss, *Securities Regulation* 698. It is well established that neither Section 4(3) nor Section 4(4) applies to transactions involving an issuer or underwriter. See *Securities and Exchange Commission* v. *Computronics Industries Corp.*, *supra*, 294 F. Supp. at 1138-1139; *Winter* v. *D. J. & M. Investment and Construction Corp.*, 185 F. Supp. 943, 946 (S.D. Cal.); *Securities and Exchange Commission* v. *Mono-Kearsarge Consolidated Mining Co.*, 167 F. Supp. 248, 256 (D. Utah); *Ira Haupt & Co.*, 23 S.E.C. 589,

604 and footnote 23; I Loss, *Securities Regulation* 183, 256-258, 697-698; Jennings and Marsh, *Securities Regulation* 334-336 (2d ed., 1968); Securities Act Release No. 4445, pp. 1-2 (1962); Securities Act Release No. 4818, pp. 1-2 (1966).[6]

Petitioners assert (Pet. 25-26) that the decision here imposes an unreasonable duty of investigation on brokers, and will, they contend, deprive small investors of access to the securities markets since brokers probably would decline all orders from individuals who might possibly be underwriters rather than investigate. The decision, however, comports with well established and long standing principles. Professionals in the securities business such as petitioners are under an affirmative duty to make reasonable inquiry so as to assure that transactions in which they participate do not violate the federal securities laws. See, *e.g.*, *Hanly* v. *Securities and Exchange Commission*, 415 F.2d 589, 597 (C.A. 2); *Nees* v. *Securities and Exchange Commission*, 414 F.2d 211, 220 (C.A. 9); *Barnett* v. *United States*, 319 F.2d 340, 343 (C.A. 8); *Securities and Exchange Commission* v. *Mono-Kearsarge Consolidated Mining Co.*, *supra*, 167 F. Supp. at 259.

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[6] In the situation here it does not matter, as petitioners suggest (Pet. 19-20, 22), whether Quinn Co. and Dornacker were themselves underwriters. The exemptions under Section 4 of the Act apply to transactions, not persons. *Securities and Exchange Commission* v. *Chinese Consolidated Benevolent Ass'n, Inc.*, *supra*, 120 F. 2d at 741. The transactions in this case involved White, who was an underwriter, and accordingly were not exempt.

CONCLUSION

For the foregoing reasons, the petition for a writ of certiorari should be denied.

Respectfully submitted.

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